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No. 637

In the Supreme Court of the United States

OCTOBER TERM, 1958

MERCHANTS WAREHOUSE COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 46a-65a) are not officially reported. The opinion of the Court of Appeals (Pet. 1a-8a) has not yet been officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on October 24, 1958. (Pet. 9a.) The petition for a writ of certiorari was filed on January 9, 1959. The jurisdiction of thjs Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether, in computing invested capital for purposes of an excess profits tax credit, taxpayer could include its bonds in "borrowed invested capital" only to the extent of that portion of the total capital actually invested which the bonds represented.

STATUTE INVOLVED

The statutory provisions involved are Sections 113(a), 711(a), 712(a), 714, 715, 716, 717, 718(a) and 719(a) of the Internal Revenue Code of 1939. These provisions are set forth in the Appendix, *infra*, pp. 9-13.

STATEMENT

The material facts, as found by the Tax Court (R. 46a-56a), may be summarized as follows:

Prior to 1934 the Wholesale Merchants Warehouse Company owned and operated a warehouse property known as Cummins Station. The corporation had bonds outstanding in the principal amount of $550,000, secured by a deed of trust on the warehouse property. In 1934 the corporation defaulted on the interest due on the bonds and the trustee took possession of the property. In subsequent court proceedings the trustee was ordered to foreclose. A court-appointed appraiser valued the property at $375,000. The foreclosure sale was held on February 8, 1937. At that time $535,000 of the corporation's outstanding bonds had been deposited with a bondholders' committee and the committee was entitled under the terms of sale to tender bonds and interest coupons in part payment of the purchase price. The bondholders' committee bid in the warehouse property for $350,000

and assumption of 1937 taxes. It then organized the taxpayer corporation, Merchants Warehouse Company, Inc., to take over the property. It directed the trustee to deed the property to taxpayer and, in exchange therefor, taxpayer issued to the committee for distribution to depositing bondholders $535,000 of new 15-year 5 per cent bonds plus all taxpayer's authorized stock, *i.e.*, 535 shares of no par common. The trustee had accumulated cash from operating the warehouse, and part of such sum was used to pay off non-depositing bondholders. The balance was distributed to taxpayer as new owner of the property. Of this balance $5,350 was credited by taxpayer to capital, giving the 535 shares issued a paid-in value of $10 each, and the remainder was distributed *pro rata* to the stockholders. Each depositing bondholder received, for each bond deposited, a new $1,000 bond, a share of stock, and $22.70 in cash. (R. 46a-48a.)

Two issues were presented in this litigation. The first was the proper basis of the warehouse building in the hands of taxpayer for the purpose of computing depreciation deductions.[1] It was undisputed that taxpayer acquired the warehouse property in a nontaxable exchange, and hence that taxpayer's basis for the property was the same as its transferor's, under Section 113(a)(8) of the 1939 Code. Since the transferor (the bondholders' committee) purchased the property at a foreclosure sale, it was further undisputed that the transferor's basis (and hence the taxpayer's) was the fair market value of the property at that time. Thus

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[1] While this issue is not raised by the petition, its disposition below is pertinent to the second issue which is raised by the taxpayer here.

the dispositive question with respect to depreciation was the fair market value of the warehouse property in 1937, which became its unadjusted basis in taxpayer's hands pursuant to Section 113(a)(8). (R. 57a.) The Tax Court found that the fair market value of the property in 1937 was $450,000, of which $150,000 was allocable to the land and $300,000 to the building. (R. 56a.) The Court of Appeals sustained this finding. (Pet. 1a-6a.)

The second issue below involved the computation of taxpayer's invested capital for the purpose of the excess profits credit. In computing invested capital on its 1943 and 1944 returns, taxpayer declared as equity invested capital, the amount of $5,350 under the heading, "Money paid in for stock, or as paid-in surplus, or as a contribution to capital." As borrowed capital, taxpayer included the face amount of the $535,000 in bonds which it had issued in 1937. The Commissioner did not disturb the nominal equity invested capital figure, but determined that, in computing borrowed capital, taxpayer could only include the bonds in an amount equal to the fair market value of the warehouse property. (The Commissioner originally determined that the fair market value was $350,000, but accepted the Tax Court's subsequent valuation of $450,000, noted above.) (R. 55a-56a.)

The Tax Court's approach was based upon the same ultimate premise as the Commissioner's, *i.e.*, that the taxpayer's total invested capital could not exceed the fair market value of the warehouse property plus the relatively small amount of cash paid in for stock ($5,350). More particularly, the Tax Court held that taxpayer's equity invested capital and borrowed invested capital could not be determined independently

of each other, since taken together they should reflect taxpayer's total invested capital. The court then held that, since taxpayer's total capital investment inhered in the warehouse property,[2] it followed that taxpayer's equity invested capital and borrowed invested capital were to be computed by allocating the unadjusted basis of the property (*i.e.*, fair market value) between stock and bonds in accordance with their respective fair market values. Of the total fair market value of the property ($450,000), the court allocated $75,000 to stock and $375,000 to bonds, as the respective fair market values of those securities, and as the amounts to be included, respectively, in equity invested capital and borrowed capital. (R. 61a-65a.) The Court of Appeals affirmed. (Pet. 6a-7a.)

ARGUMENT

1. The courts below held that, in the computation of taxpayer's invested capital for purposes of an excess profits tax credit, taxpayer could include its bonds in "borrowed invested capital" only to the extent that total invested capital was properly allocable to the bonds. In assailing that ruling, taxpayer renews its contention below that its bonds are includible in "borrowed invested capital" at face value ($535,000) without regard to its total capital investment ($455,350).

2. We submit, however, that the issue was correctly decided below. During the tax years (1943 and 1944) the computation of a corporate taxpayer's excess profits

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[2] While the Tax Court did not refer explicitly in its opinion to the $5,350 paid in for stock as part of taxpayer's invested capital, it obviously considered that it was includible. The Rule 50 computation adopted by the Tax Court includes this sum as equity invested capital.

credit on the basis of invested capital was governed by Sections 714-719 of the 1939 Code, Appendix, *infra*, pp. 11-13 (since repealed). Under Section 714 the credit was a fixed percentage of the taxpayer's "invested capital" for the taxable year.[3] Invested capital was divided into two categories, equity and borrowed invested capital (See Sections 718 and 719), but the two categories were merely components of the total invested capital, which could not be a fair measure of a taxpayer's normal profits unless geared to capital *actually invested* by the taxpayer. See *Hart-Bartlett-Sturtevant G. Co.* v. *Commissioner*, 182 F. 2d 153, 158 (C.A. 8th); *Graves, Inc.* v. *Commissioner*, 16 T.C. 1566, 1572, affirmed, 202 F. 2d 286 (C.A. 5th).

It is evident of course that taxpayer's total *actually invested* capital was represented by the warehouse property plus opening cash of $5,350. Since the computations of equity invested capital and "borrowed invested capital" must be so coordinated as to reflect the total invested capital, the courts below correctly held that the fair market value of the warehouse property is allocable between the stock and bonds and that the fair market value represented by the bonds is the amount includible in "borrowed invested capital." See also, *Southern Fertilizer & Chemical Co.* v. *Edwards* (M.D. Ga.), decided June 23, 1955 (48 A.F.T.R. 1953), where it was held that the bonds issued in a recapitalization were includible in borrowed capital "only to the extent of their fair market value when issued" (p. 1955).

Taxpayer fails to cite, nor is there, any case in which a court has rejected this approach. It attempts to distinguish the above authorities and others cited by the

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[3] See *Walsh Holyoke Steam B. Wks.* v. *Commissioner*, 160 F. 2d 185 (C.A. 1st).

Tax Court, making much of factual differences. But these differences cannot obscure the rationale of the holdings as to the nature of "invested capital" for the purposes of the excess profits credit. The definition of "borrowed capital" in Section 719(a) is in no way inconsistent with the courts' approach. So far as pertinent, that definition extends to "The amount of the outstanding indebtedness * * * of the taxpayer which is evidenced by a bond, * * *." In the light of the overall statutory scheme, this obviously means the amount of indebtedness evidenced by bonds which reflects, or constitutes a part of, the total capital of the taxpayer in fact invested. Taxpayer's theory—that "amount" means face amount, so long as *bona fide*, without regard to total invested capital—would defeat the very purpose of the excess profits credit, which is to reflect a fair return in normal times upon the amount actually invested in the enterprise.

3. The question presented is narrow and has little current importance; and there is no conflict of decisions. The excess profits tax provisions involved in this case have long since been repealed, and, indeed, there are no similar provisions in force today. As to litigation which may still be instituted with respect to the liability of corporate taxpayers under the World War II and Korean War excess profits tax laws, it is a matter of conjecture as to the number of cases, if any, which will involve the precise issue presented here.

CONCLUSION

The petition for certiorari should be denied.

Respectfully submitted,

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FEBRUARY, 1959.

APPENDIX

Internal Revenue Code of 1939:

Sec. 113: ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), * * *

* * * * *

then the basis shall be the same as it would be in the hands of the tranferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * *

(26 U.S.C. 1952 ed., Sec. 113.)

Subchapter E [as added by Sec. 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974]—Excess Profits Tax.

Part I

* * * * *

Sec. 711. EXCESS PROFITS NET INCOME.

(a) *Taxable Years Beginning After December 31, 1939.*—The excess profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13(a)(2), for such year except that the following adjustments shall be made.

* * * * *

(2) *Excess profits credit computed under invested capital credit.*—If the excess profits credit is computed under section 714, the adjustments shall be as follows:

* * * * *

(B) *Interest.*—The deduction for interest shall be reduced by an amount equal to 50 per centum of so much of such interest as represents interest on the indebtedness included in the daily amounts of borrowed capital (determined under section 719(a));

* * * * *

(26 U.S.C. 1952 ed., Sec. 711.)

Sec. 712. EXCESS PROFITS CREDIT—ALLOWANCE.

(a) [as amended by Sec. 13 of the Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17] *Domestic Corporations.*—In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 712.)

SEC. 714 [as amended by Sec. 201(b) of the Revenue Act of 1941, c. 412, 55 Stat. 687]. EXCESS PROFITS CREDIT—BASED ON INVESTED CAPITAL.

The excess profits credit, for any taxable year, computed under this section, shall be the amount shown in the following table:

If the invested capital for the taxable year, determined under section 715 is:	The credit shall be:
Not over $5,000,000—	8% of the invested capital.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 714.)

Sec. 715. DEFINITION OF INVESTED CAPITAL.

For the purposes of this subchapter the invested capital for any taxable year shall be the average invested capital for such year, determined under sec-

tion 716, reduced by an amount computed under section 720 (relating to inadmissible assets). * * *

(26 U.S.C. 1952 ed., Sec. 715.)

Sec. 716. AVERAGE INVESTED CAPITAL.

The average invested capital for any taxable year shall be the aggregate of the daily invested capital for each day of such taxable year, divided by the number of days in such taxable year.

(26 U.S.C. 1952 ed., Sec. 716.)

Sec. 717. DAILY INVESTED CAPITAL.

The daily invested capital for any day of the taxable year shall be the sum of the equity invested capital for such day plus the borrowed invested capital for such day determined under section 719.

(26 U.S.C. 1952 ed., Sec. 717.)

Sec. 718. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (un-

adjusted) for determining loss upon sale or exchange. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 718.)

Sec. 719. BORROWED INVESTED CAPITAL.

(a) *Borrowed Capital.*—The borrowed capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following:

(1) [as amended by Sec. 230(b)(2) of the Revenue Act of 1942, c. 619, 56 Stat. 798] The amount of the outstanding indebtedness (not including interest) of the taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus,

* * * * * *

(26 U.S.C. 1952 ed., Sec. 719.)

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